SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Monteith
Analyst: Jeani Brent
Bill Number: SB 1881
Related Bills: See Legislative History
Telephone: 845-3410
Amended Date: 04/13/98
Attorney: Doug Bramhall
Sponsor:

SUBJECT: Enterprise Zone/Research and Development Credit

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

__X__ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced February 19, 1998 .

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ____________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would provide businesses operating a trade or business in a newly designated enterprise zone a credit for 80% of the amount paid for research and development, as defined, performed at the taxpayer's trade or business located in the new enterprise zone.

Under the Government Code, this bill would require the Trade and Commerce Agency (TCA) to designate an additional enterprise zone. This bill would specify that TCA could designate only an area that meets certain additional criteria. This bill would specify that all tax incentives provided to existing enterprise zones under the Revenue and Taxation Code would apply to the new enterprise zone designated under this bill.

SUMMARY OF AMENDMENT

Under the PITL and B&CTL, the April 13, 1998, amendments would make the following changes:

1. Extend the sunset date of the credits from January 1, 2009, to January 1, 2020.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department/Legislative Director Date Gerald H. Goldberg 4/15/98	Agency Secretary Date	By: Date:

2. Increase the percentage of research and development expenses that qualify for the credit from 75% to 80%.

3. Remove references to businesses operating in the County of Merced and instead refer to businesses located in the enterprise zone that would be designated under this bill.

Under the Government Code, the April 13, 1998, amendments would remove the provisions relating to research and development incentive program and instead require TCA to designate a new enterprise zone, as discussed below.

The amendments would resolve one of the implementation considerations discussed in the department's analysis of the bill as introduced February 19, 1998, by providing a definition for "research and development." The remaining implementation considerations still apply and are included below for convenience.

EFFECTIVE DATE

The PITL and B&CTL provisions would apply to taxable or income years beginning on or after January 1, 1998. The Government Code provisions would be operative on January 1, 1999.

LEGISLATIVE HISTORY

AB 3, AB 82, AB 1937, AB 2205, SB 1631, SB 2079 (1998); AB 69, AB 797 (Stats. 1997, Ch. 461), AB 1217 (Stats. 1997, Ch. 602), SB 200 (Stats. 1997, Ch. 609), SB 635, SB 965 (Stats. 1997, Ch. 603); AB 2456 (1996), AB 296 (Stats. 1996, Ch. 953), SB 715 (Stats. 1996, Ch. 952), SB 2023 (Stats. 1996, Ch. 955); SB 712 (Stats. 1995, Ch. 494); AB 2206 (Stats. 1994, Ch. 853), SB 1438 (Stats. 1994, Ch. 754), SB 1770 (Stats. 1994, Ch. 755).

PROGRAM HISTORY/BACKGROUND

California has five types of economic development areas that have similar tax incentives:

- Enterprise Zones,
- Los Angeles Revitalization Zone (LARZ),
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA)

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LARZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	X	
Hiring Credit	X	X	X	X	X
Construction Hiring Credit		X			
Employee Wage Credit	X				
Business Expense Deduction	X	X	X	X	
Net Interest Deduction	X	X			
Net Operating Loss	X	X	X	X	

* NOTE: the LARZ expires December 1, 1998.

SPECIFIC FINDINGS

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an enterprise zone. Using specified criteria, TCA designates enterprise zones from the applications received from the governing bodies. Enterprise zones are designated for 15 years, and TCA has designated the 39 enterprise zones authorized under existing law.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within enterprise zones. These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special net operating loss treatment. Additionally, the Enterprise Zone Act provides incentives to taxpayers other than those operating in the enterprise zone: a net interest deduction for businesses that make loans to businesses within the enterprise zone and a tax credit for employees working in an enterprise zone. See Attachment A for a detailed discussion of each tax incentive.

Existing federal and state laws provide various tax credits that are designed to provide tax relief for taxpayers who must incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits).

Existing federal and state laws provide a credit for specified percentages of the amount of a taxpayer's qualified research expenditures. Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) a specified percentage of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Further, the research must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or qualify of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

SB 1881 would require the TCA to select an application for an enterprise zone from a county that meets the following criteria:

1. The county has a population of no more than 1.2 million residents.

2. The unemployment rate in the county is at least 15%.

3. At least 30% of the county's population is receiving public assistance.

4. The median family income within the county is $29,000 or less.

5. The county authorizes a research and development incentive payment in the form of an annual reimbursement for local ad valorem property tax revenue, as specified.

This bill, under the Government Code, would define "research and development" as research performed or completed to discover information that is technological in nature and intended to be useful in the development of a new or improved business component. In addition, to qualify for the incentive payment, the research must be related to elements of a process or experimentation for a functional purpose, including any of the purposes provided under the federal research and development credit relating to new or improved function or relating to performance, reliability, or quality.

Under the Government Code, **this bill** would specify that all tax incentives provided to existing enterprise zones under the Revenue and Taxation Code would apply to the new enterprise zone designated under this bill.

Under the PITL and B&CTL, **this bill** would provide an additional credit for businesses operating a trade or business in the new enterprise zone for 80% of the amount paid for research and development, as defined in the Government Code, performed at the taxpayer's trade or business located in the new enterprise zone. Since this bill does not specify otherwise, the general rules regarding the division of credits among taxpayers would apply. The credit would not reduce regular tax below tentative minimum tax for alternative minimum tax purposes.

Policy Considerations

This bill would allow taxpayers in certain circumstances to claim multiple special tax benefits (one or two credits and a trade or business expense deduction) for the same item of research expense. Taxpayers could claim two state credits – the regular research and development credit and the credit provided under this bill. In addition, the bill would require the county to provide these taxpayers an incentive payment for the same item of research expense.

Although this bill requires that a qualified taxpayer "operate a trade or business located in the new enterprise zone," utilization of the credit is not limited to the taxpayer's business activities within the new enterprise zone. This differs from the enterprise zone and Los Angeles Revitalization Zone (LARZ) credits and net operating loss rules in that many of those credits and net operating loss deductions may only be offset against tax liability attributable to the enterprise zone or LARZ taxable or net income.

Implementation Considerations

Under the PITL and B&CTL, "research and development" would be defined by reference to the Government Code definition. The Government Code subparagraph provides a definition, followed by additional criteria that must be met to qualify for the county incentive payment. It is unclear whether research and development for the PITL and B&CTL credits must meet only the first criterion or all criteria listed in the Government Code subparagraph.

This bill would allow an unlimited carryover for the research and development credit. Recently enacted credits have contained a limited carryover since credits typically are exhausted within eight years.

Technical Consideration

In subdivision (a) of Section 23604.5, the proposed amendments did not replace "County of Merced" with "enterprise zone designated pursuant to Section 7073.6 of the Government Code."

FISCAL IMPACT

Departmental Costs

If this bill is amended to resolve the implementation consideration addressed in this analysis, the bill would not significantly impact the department's costs.

Tax Revenue Estimate

The estimated revenue impact of this bill is shown in the following table:

Revenue Impact of SB 1881 as amended 4/8/98 Effective for Tax Years Beginning on and After January 1, 1998 Assumed enactment after June 30, 1998 $ Millions				
	1999-00	2000-01	2001-02	2002-03
Research and Development Credit	($7)	($14)	($28)	($51)
Enterprise Zone Incentives	*	**	($1)	($1)
Total	($7)	($14)	($29)	($52)
* Losses less than $250,000 ** Losses less than $500,000				

This analysis does not take into account any change in employment, personal income, or gross state product that might result from this bill becoming law.

The estimates are discussed separately below.

Revenue Estimate Discussion: Research Credit

The research and development Credit revenue impact was estimated as follows. First, the 1994 U.S. total research and development was prorated to California based on the 1991 California and U.S. research and development levels given by the National Science Foundation. Next, it was assumed that only Merced County would meet the criteria specified in the bill. Third, qualified research and development in 1994 was estimated as the product of California research and development and the ratio of the county over California nonagricultural employment. Estimated research and development was adjusted further to account for the following factors:

- Existing businesses in the county tend to be involved in less research and development than in other parts of the state.

- It takes time for taxpayers to learn about the new tax laws and to fully implement the proper responses.
- Many businesses outside the county would respond to the incentives of this proposal by either moving or expanding research and development activity into the county.
- The credit would be limited by alternative minimum tax.

Future qualified research and development expenditures were estimated using the Department of Finance’s projection of corporate profits. Finally, the revenue impact was estimated from the amount of qualified research and development credits that can be applied against available tax liabilities.

If SB 1881, as currently written, is enacted, taxpayers would receive multiple benefits from conducting research and development in the county – research and development incentive payments from the board of supervisors, the incremental research and development credit under current law, business expense deduction, and this proposed research and development credit. Furthermore, it is assumed that the research and development credit generated under this bill by a company located in the county could be used to offset taxes incurred by the same company’s operations located elsewhere.

Revenue Estimate Discussion: Enterprise Zone

Revenue losses under the Personal Income Tax Law and the Bank and Corporation Tax Law would depend on the number of businesses that would purchase qualified property subject to the sales tax, the amount of wages paid to qualifying employees, and the state tax liabilities of employers claiming tax benefits.

Because the effectiveness of any new enterprise zone is unknown, the annual average of $1 million is assumed to be the equilibrium revenue loss of newly proposed enterprise zones. However, the cumulative loss for the first two years is expected to be less than $500,000.

BOARD POSITION

Pending.

The Board considered this bill, as introduced, at its March 26, 1998, meeting, and took no position (Julie Bornstein, acting on behalf of Controller Kathleen Connell was neutral, Member Dean Andal voted in support, and Robin J. Dezember, acting on behalf of Member Craig L. Brown, abstained). However, the Board has not considered the bill as proposed to be amended.

SENATE BILL 1881 (MONTEITH)
As Proposed To Be Amended
Attachment A

Enterprise Zone Sales or Use Tax Credit

The enterprise zone sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an enterprise zone. The amount of the credit is limited to the tax attributable to enterprise zone income. Qualified machinery is defined as machinery and machinery parts used to (1) manufacture, process, combine, or otherwise fabricate a product; (2) produce renewable energy resources; or (3) control air or water pollution. In addition, qualified machinery must be purchased and placed in service before the enterprise zone designation expires. The maximum value of property that may be eligible for the enterprise zone sales or use tax credit is $1 million for individuals and $20 million for corporations.

Enterprise Zone Hiring Credit

A business located in an enterprise zone may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated an enterprise zone and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the enterprise zone and at least 50% must be performed inside the enterprise zone. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on enterprise zone income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage. The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Enterprise Zone Business Expense Deduction

A business located in an enterprise zone may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the enterprise zone. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after designation	Maximum deduction
0 to 24	$40,000
25 to 48	30,000
48 and over	20,000

Enterprise Zone Net Operating Loss Deduction

A business located in an enterprise zone may elect to carry over 100% of the enterprise zone net operating losses (NOLs) to deduct from enterprise zone income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the LAMBRA.

Enterprise Zone Net Interest Deduction

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone and the lender may not have equity or other ownership interest in the enterprise zone trade or business.

Enterprise Zone Employee Wage Credit

Certain disadvantaged individuals who are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of “qualified wages,” defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer’s entire taxable income.